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## Tokyo Moves On Fiscal Policy

July 31 was a busy day for Yasuhiro Nakasone's cabinet. Both a tax plan for the current fiscal year and spending guidelines for fiscal 1988 were approved. Although one-quarter of fiscal 1987 has already passed, the government is still operating under FY 1986 tax rules because intense opposition party resistance prevented consideration of a tax package earlier this year (see JEI Report No. 17B, May 1, 1987). At the same time, a surprising surge in financial and real estate activity yielded higher than expected revenues, making a stimulative fiscal policy more palatable. The revenue picture is so positive that, for the first time in several years, the Ministry of Finance is planning to allow discretionary general account expenditures to rise in fiscal 1988. After being bound by austerity, fiscal policy is suddenly Tokyo's tool of choice.

The guidelines for compiling the FY 1988 general account budget reveal a 1.8 percent increase to Y33.2 trillion ($221.3 billion at Y150=$1.00) in

discretionary spending, the first increase planned since FY 1983. When mandatory items (interest payments on the national debt and transfers to local governments) are included, projected total general account expenditures rise to approximately Y54.8 trillion ($365.3 billion), 1.2 percent above FY 1987's guideline. The principal reason for the increase is MOF's decision to allow capital outlays to remain at year-earlier levels rather than seek a 5 percent reduction. Under this new rule, public works will be increased by approximately Y1.2 trillion ($8 billion) or 20 percent. MOF's guideline calling for a 10 percent reduction in current operating budgets remains in effect, however, cutting an estimated Y350 billion ($2.3 billion) from total spending.

Defense spending and official development assistance will continue to receive special treatment. Defense outlays are expected to rise 6.2 percent or Y218 billion ($1.5 billion) to Y3,735.4 billion ($24.9 billion), while ODA is projected to jump 8.6 percent or Y56.6 billion ($377.3 million). While the defense hike guideline is the lowest since FY 1982, the anticipated increase in ODA is well above FY 1987's 7.5 percent level, reflecting Tokyo's commitment to play a greater role in global development. Other items slated to receive increases include: salaries (Y495 billion or $3.3 billion), social welfare (Y16.9 billion or $112.7 million) and science (Y24 billion or $160 million). Thanks to low world prices for oil during the past year, energy-related outlays will be reduced by Y129 billion ($860 million).

The Finance Ministry reported that FY 1986 general account revenues totaled Y56,489.1 billion ($376.6 billion), Y2,848.7 billion ($19 billion) more than expected. Despite the negative impact of the yen's appreciation on corporate and personal income, the surplus was generated by a boom in financial and real estate tax receipts -- hardly surprising since land prices have paralleled the ascent of equity market indexes over the past year. Local governments will receive Y575.5 billion ($3.8 billion) of the windfall, while the central government's share will help fund the FY 1987 supplementary budget and planned income tax reductions. MOF also reported that higher-than-projected revenues eliminated the need to issue Y240 billion worth of deficit financing and construction bonds in FY 1986, reducing the shortfall of total general account outlays.

Tax evasion in FY 1986 also reached record heights, ministry records show. MOF investigations revealed that Y57.2 billion ($381.3 million) in income went unreported, translating into tax and penalty losses of Y37.4 billion ($249.3 million). Of the 179 cases prosecuted by the National Tax Agency, eight involved unreported income of over Y1 billion ($6.7 million) and 38 uncovered avoidance of over Y400 million ($2.7 million) that averaged out to Y300 million ($2 million). The figures were the worst ever, officials said.

Hoping to improve the situation, the government's FY 1987 tax package addresses this and other areas. While income reporting requirements will be strengthened, income tax reduction and taxes on interest income are the major issues. Because the government was unable to win Diet approval for a new 5 percent value-added tax, the planned personal income tax reduction was scaled back to Y1.3 trillion ($8.7 billion) for FY 1987. This will be achieved by reducing the number of national tax brackets from 15 to 13 and by reducing tax rates; the top marginal rate falls from 70 percent to 60 percent, while the lowest rate of 10.5 percent will apply to taxable incomes of Y1.2 million

($8,000) rather than Y500,000 ($3,333). Low- and middle-income earners will clearly receive the biggest share of the tax cut -- a tactic aimed at softening opposition party resistance (see Table 1).

Table 1: Impact of Proposed Income Tax Changes

| Annual Taxable Income (Y millions) | Current Tax (in yen) | Average Rate | Proposed Tax (in yen) | Average Rate | Tax Cut (in yen) | Percent Reduction |
|---|---|---|---|---|---|---|
| Y3 | Y78,125 | 2.6% | Y48,450 | 1.6% | Y29,675 | 38.0% |
| 4 | 215,750 | 5.4 | 168,250 | 4.2 | 47,500 | 22.0 |
| 5 | 394,050 | 7.9 | 322,300 | 6.4 | 71,750 | 18.2 |
| 6 | 614,450 | 10.2 | 518,500 | 8.6 | 95,950 | 15.6 |
| 7 | 890,200 | 12.7 | 771,600 | 11.0 | 118,600 | 13.3 |
| 8 | 1,204,400 | 15.1 | 1,053,200 | 13.2 | 151,200 | 12.6 |
| 9 | 1,538,800 | 17.1 | 1,355,600 | 15.1 | 183,200 | 11.9 |
| 10 | 1,887,100 | 18.9 | 1,698,800 | 17.0 | 188,300 | 10.0 |
| 12 | 2,724,850 | 22.7 | 2,604,150 | 21.7 | 120,700 | 4.4 |
| 15 | 4,182,250 | 27.9 | 4,065,750 | 27.1 | 116,500 | 2.8 |
| 20 | 7,008,250 | 35.0 | 6,891,750 | 34.5 | 116,500 | 1.7 |
| 30 | 13,504,150 | 45.0 | 13,120,100 | 43.7 | 384,050 | 2.8 |

Note: Based on a salaried-income family with two children filing a joint return.

Source: Asahi Shimbun, August 1, 1987.

Nevertheless, the opposition points out that the proposed reduction is only half as much as originally planned since several scheduled deductions have been dropped and a reduction in corporate tax rates has been postponed. To counter this the government is emphasizing the personal tax reductions planned for fiscal 1988: Y900 billion ($6 billion) in national income taxes and Y500 billion ($3.3 billion) in local income taxes. Eventually, under the government's plans, individual taxes will be cut by a total of Y3 trillion ($20 billion): Y2.25 trillion ($15 billion) in national taxes and Y750 billion ($5 billion) in local taxes. A timetable for this final stage is not included in the bills, however.

Opposition parties are not only unimpressed, but are very upset because the government is going ahead with plans to reform the popular maruyu tax-exempt savings system, which exempts interest income on particular postal savings accounts of up to Y3 million ($20,000). Beginning January 1, 1988 a flat 20 percent tax will be levied on interest income (see Table 2). The only exception is interest earned by senior citizens (over 65 years), fatherless families and the physically handicapped; for these groups the tax-exempt ceiling will be raised to Y9 million ($60,000). In addition, personal accounts at private banks that currently qualify for maruyu treatment will be taxed at the new 20 percent rate, except for housing and pension accounts, which will be taxed at a rate of 5 percent. The proposal contains several concessions to the

opposition: originally the new taxes kicked in on October 1 of this year; the ceiling for surviving maruyu accounts was originally the same Y3 million ($20,000); and housing and pension accounts were to be taxed at a 10 percent rate.

Table 2: Impact of Interest Income Tax Reform

(in thousands of yen with percentage change in parenthesis)

| Annual Taxable Income | Y2,800 | Y4,210 | Y5,350 | Y6,720 | Y10,180 |
|---|---|---|---|---|---|
| Interest Income | 1,930 | 3,320 | 5,250 | 5,420 | 8,790 |
| Current National and Local Income Taxes | 500 | 2,300 | 4,330 | 7,500 | 18,330 |
| Proposed National and Local Income Tax Reduction | -280 (55.8%) | -500 (21.7%) | -740 (17.1%) | -1,100 (14.7%) | -1,820 (9.9%) |
| Interest Income Tax | 140 | 240 | 310 | 390 | 630 |
| Total Tax Change | -140 (28.2%) | -260 (11.3%) | -430 (10.4%) | -710 (9.5%) | -1,190 (6.5%) |

Note: Based on a salaried-income family with two children filing a joint return.

Source: Asahi Shimbun, August 1, 1987.

The opposition parties remain adamantly against the changes and are boycotting Diet proceedings, charging that the Liberal Democratic Party is ignoring a pledge to respect the views of a special joint tax committee (see JEI Report No. 29B, July 31, 1987). A similar boycott during the last regular Diet session forced the government to withdraw its value-added tax proposal. If no progress is made before the 10-day August 8 recess, this package may also face defeat. Prime Minister Nakasone will undoubtedly pull out all the stops to win its passage before his term as Liberal Democratic Party president ends October 30. Opposition parties, on the other hand, will surely try to prevent this. If public sentiment swings in favor of the opposition on this issue as it did on the value-added tax plan, this part of the government's fiscal plan could be shattered.

Jon Choy

## Japan's Capital Outflow Swells

Japan's balance of payments in the first half of 1987 indicates that it continues to be a major supplier of capital to the world, reflecting the country's high saving rate. The net long-term capital outflow totaled $76.7 billion, up 60.2 percent from the first half of 1986 (see Table 1), with foreign

securities accounting for about three-fourths of the total. Following three months of sluggish buying, net purchases of foreign bonds reached a record $12.3 billion in June. The June surge, encouraged by the relative stability of exchange rates and the rise in U.S. long-term interest rates, brought total net foreign bond purchases to $48.5 billion for the first six months of 1987 (see Table 2).

Table 1: Japan's Balance of Payments

(in millions of dollars)

| | Trade Balance | Exports (f.o.b.) | Imports (f.o.b.) | Services (net) | Current Account Balance | Long-Term Capital (net) |
|---|---|---|---|---|---|---|
| 1982 | $18,079 | $137,663 | $119,584 | $-9,848 | $6,850 | $-14,969 |
| 1983 | 31,454 | 145,468 | 114,014 | -9,106 | 20,799 | -17,700 |
| 1984 | 44,257 | 168,290 | 124,033 | -7,747 | 35,003 | -49,651 |
| 1985 | 55,986 | 174,015 | 118,029 | -5,165 | 49,169 | -64,542 |
| 1986 | 92,827 | 205,591 | 112,764 | -4,932 | 85,845 | -131,461 |
| 1986:I | 14,552 | 44,813 | 30,261 | -1,145 | 12,668 | -18,990 |
| 1986:II | 23,922 | 52,270 | 28,348 | -374 | 23,099 | -28,882 |
| 1986:III | 26,793 | 53,859 | 27,066 | -1,922 | 24,413 | -38,410 |
| 1986:IV | 27,560 | 54,649 | 27,089 | -1,491 | 25,665 | -45,179 |
| 1987:I(p) | 23,159 | 50,379 | 27,220 | -1,510 | 20,585 | -32,455 |
| 1987:II(p) | 24,823 | 55,822 | 30,999 | -1,567 | 22,570 | -44,233 |

Source: Bank of Japan

Table 2: Japanese Net Purchases of Foreign Securities

(in millions of dollars)

| | Bonds | | | Stocks | | |
|---|---|---|---|---|---|---|
| | Purchases | Sales | Net | Purchases | Sales | Net |
| 1982 | $16,980 | $10,904 | $6,076 | $1,126 | $975 | $151 |
| 1983 | 22,905 | 10,400 | 12,505 | 2,106 | 1,445 | 661 |
| 1984 | 56,348 | 29,575 | 26,773 | 1,570 | 1,519 | 51 |
| 1985 | 291,338 | 237,859 | 53,479 | 5,484 | 4,489 | 995 |
| 1986 | 1,346,989 | 1,253,965 | 93,024 | 20,917 | 13,869 | 7,048 |
| 1986:I | 251,591 | 234,330 | 17,261 | 2,793 | 1,961 | 832 |
| 1986:II | 368,271 | 343,467 | 24,804 | 3,717 | 2,260 | 1,457 |
| 1986:III | 357,331 | 330,980 | 26,351 | 6,481 | 4,473 | 2,008 |
| 1986:IV | 369,796 | 345,188 | 24,608 | 7,926 | 5,175 | 2,751 |
| 1987:I(p) | 377,850 | 354,648 | 23,202 | 13,925 | 9,386 | 4,539 |
| 1987:II(p) | n.a. | n.a. | 25,267 | n.a. | n.a. | 5,480 |

Source: Bank of Japan

Although bonds remained their largest overseas holding, Japanese investors moved strongly into foreign stocks in 1987's first half. Net purchases of foreign equities (mainly American), which rose from $1 billion in 1985 to $7 billion last year, exceeded $10 billion in the January-June period. With prices on the Tokyo Stock Exchange at unprecedented levels, the relatively low price-earnings ratios in the U.S. market are attracting Japanese investors. In addition, many analysts believe the profit outlook for big U.S. companies is bright due to tax reform and the benefits of a weaker dollar.

The latest balance of payments figures suggest that the sharp appreciation of the yen is having its long-awaited impact on Japan's current account (merchandise trade, services and transfers). After 18 consecutive quarterly increases, the surplus in the April-June 1987 quarter fell 2.3 percent from the year-earlier level to $22.6 billion. The decline was primarily a result of a larger services deficit, resulting from an overseas travel boom fanned by the strong yen. The increased red ink in the travel and transportation categories more than offset a rise in net investment income.

The current account surplus for all of 1987, however, is likely to break last year's $85.8 billion record, since at $43.2 billion in the January-June period it was 20.7 percent above the year-earlier figure. The trade surplus also climbed sharply to $48 billion compared to $38.5 billion. Although the changes in exports and imports that began in 1986 will eventually reduce the surplus, a recent report by Japan's central bank conceded that the surplus in nominal terms is likely to remain sizable in the near future.

The Bank of Japan report concludes that "to reduce the surplus to an internationally acceptable level in the long run, therefore, an overhaul of Japan's economic structure is required in such a way as to lessen its chronic dependence on external demand." The reallocation of resources away from the tradable goods sector indicates that this restructuring is already under way. Investment in nonmanufacturing businesses, for example, has increased rapidly, attracted by their greater profitability. According to the Industrial Bank of Japan, it rose 14.8 percent in FY 1986, compared to an 8.6 percent decline in the manufacturing sector. In addition, nonmanufacturing employment expanded by 690,000 last year in contrast to the loss of 90,000 manufacturing jobs (see JEI Report No. 27B, July 17, 1987). A second significant trend is the shift to overseas production. Direct foreign investment climbed 82.7 percent to $22.3 billion in FY 1986, propelled in part by a 61.8 percent jump to $3.8 billion in the outflow of money for manufacturing and assembly operations (see JEI Report No. 25B, July 2, 1987).

Randall S. Jones

## Tokyo Tackles Problem Of Rising Land Prices

Soaring land prices have caused an uproar in Japan and pose a difficult political problem for the government. Driven by speculation, prices in residential and business districts in central Tokyo rose 76 percent last year, and the price spiral is now spreading to the suburbs and other major cities. The surge has created instant millionaires while making it more difficult for families to purchase homes. The average price of a home in Tokyo is more than six